

Central Intelligence Agency



Washington, D.C. 20505

20 March 1984

MEMORANDUM FOR: Mr. Frank Vargo
Deputy Assistant Secretary for Europe
Department of Commerce

FROM : [Redacted]
Director, European Analysis

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SUBJECT : Real Interest Rates in Western Europe

1. In response to your request for information on the level of real interest rates in Western Europe, I am forwarding the attached typescript, Western Europe: Are Real Interest Rates High? In general, we have concluded that real interest rates in Western Europe are presently higher than they were at the beginning of the 1976 economic recovery. Moreover, this higher level of real interest rates is holding back the pace of economic growth in the region.

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[Redacted]

3. If we can be of any further assistance, please contact [Redacted] Chief of the Economic Issues Branch, or the analyst responsible for the typescript.
Both can be reached [Redacted]

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[Redacted]

Attachment: As stated

EUR M 84-10057

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Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

20 March 1984

Western Europe: Are Real Interest Rates High?Summary

Real interest rates in Western Europe presently are higher--in some countries much higher--than the rates that existed at the start of the 1976 recovery and are about 3 percentage points above the average rate during the 1965 to 1983 period. We believe that the present level of real interest rates in Western Europe is holding back economic recovery in the region, accounting for losses in GNP growth of about 1 percentage point a year. We also believe that the high level of West European interest rates is related to--among other things--expectations of rising inflation and high government budget deficits in the region. If governments attempted to reduce budget deficits, real interest rates might fall, but the European economies--in the short run--probably would suffer lower output and employment.

This memorandum was prepared by [] the Office of European Analysis. Questions and comments may be addressed to [] Chief, Economics Issues Branch, []

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The Level of Real Interest Rates

Real interest rates are higher than usual in Western Europe - at least as measured by conventional methods (see Text Table). In most of the major countries these rates are about 3 percentage points higher than the average level of real interest rates experienced since 1965 (see Table 1). They are even higher relative to the rates that existed at the start of the 1976 cyclical upturn in Western Europe.

- West German real interest rates are presently about one percentage point higher than they were when the economy began to recover from the 1974-75 recession. Although the real rate is much less than it was two years ago, it is high relative to the average rate over the 1965-83 period (see Figure 1).
- French real interest rates were above 6 percent earlier in 1983, but by the fourth quarter had dropped down to 4.4 percent. This rate is well above the 0.7 percent rate recorded in the first quarter of 1976, at the beginning of the mid-1970s recovery. The current rate also is nearly twice the rate experienced in the 1965-83 period (see Figure 2).
- The real interest rate in the UK has been about 5 percent for the last six months. This rate is at least 3 percentage points higher than it was at the beginning of the UK recovery in the third quarter of 1976. The UK rate is down substantially from the 7.3 percent peak (fourth quarter 1981), but it is 3 to 4 percentage points higher than the average rate experienced 1965-83 (see Figure 3).
- Italian real interest rates have shown great variability (see Figure 4). As in the UK, periods of very rapid inflation have led to periods of large negative real interest rates. The median interest rate over the period 1965 to 1983 is only 0.6 percent. The current real rate of 1.7 percent is far higher than the average and almost 5 percentage points higher than the -2.9 rate existing in the beginning quarter of the 1976 recovery.

Impact of High Real Interest Rates

We believe the present level of real interest rates in Western Europe is a factor holding back economic recovery in the region. If real interest rates today were at the level existing as of the start of the 1976 recovery, real economic growth in the region would be substantially greater. We used our Linked Policy

Impact Model* (LPIM) to estimate the impact of lower real interest rates. According to model simulations, if real interest rates in Western Europe in 1984 approximated those existing at the start of the mid-1970s recovery, real GNP growth in the region would be almost 1 percentage point greater than we presently expect. If interest rates remained low through 1985, growth in that year would be more than 1 percentage-point above our baseline projection.

To estimate the impact of lower interest rates, we used the LPIM to simulate a baseline case and a lower real interest rate scenario. In our baseline projection of West European growth, real interest rates remain at fairly high levels in 1984 and 1985, and real West European GNP growth is fairly low, 1.7 percent in 1984, 2.3 percent in 1985. In the alternative scenario we let West European real interest rates fall about 3 percentage points in 1984 and 1985 from their baseline levels--approximating the rates existing at the beginning of 1976. We assumed in this case that the drop in interest rates was due to a change in expectations; it did not stem from any European (or US) policy change.

This hypothetical interest rate fall would have a substantial impact on real GNP in Western Europe and only a modest impact on inflation. Our analysis shows that investment would rise substantially throughout the region given our assumed decline in interest rates, even though capacity utilization rates are currently at low levels. Consumer spending also responds favorably in most countries to a decline in interest rates. West European real GNP rises by 0.9 percentage points in 1984, compared to the baseline projection, and 1.1 percentage points in 1985 (see Table 2). West Germany's GNP rises the most in this scenario, 1.3 percentage points in 1984, while in the smaller European countries GNP rises the least, 0.7 percentage points.

Our simulation results suggest that West European economic activity is indeed sensitive to the level of interest rates. It is somewhat misleading, however, to suppose that real interest

* The Linked Policy Impact Model is an econometric model of the world. It economically integrates individual 200-equation models of the seven major industrialized economies--West Germany, France, Italy, the United Kingdom, Canada, Japan, and the United States--and smaller models of regional economic groups--the smaller developed countries, OPEC, and non-OPEC LDCs; the centrally planned economies are represented only by trade-flow equations.

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rates could drop--magically, as it were--by 3 percentage points. It is more likely that any drop in interest rates would be accompanied by negative factors as well as positive ones. For example, if the West Europeans attempt to lower interest rates by reducing their relatively high government deficits (see Table 3), the resulting decline in fiscal stimulus would offset--in the short-run--any gain in GNP due to declining interest rates.

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Text Table

Measuring Real Interest Rates

We measure the real interest rate by subtracting the rate of inflation--measured by the GNP deflator--from the nominal long-term interest rate, using quarterly observations. The theoretical concept of real interest rates, however, suggests that the expected rate of inflation rather than the current rate of inflation should be used. In periods when the actual rate of inflation is unusually high or low, people's expectations about future interest rates may be much different from the current rate. In this case, the measure of real interest rates used here could be misleading. For example, in 1975 real interest rates in the United Kingdom dropped to -15 percent according to our measure. Nominal long-term interest rates declined from 14.3 percent in the third quarter of 1974 to 12.8 percent in the second quarter of 1975, while the inflation rate soared from 17.6 percent to 28.2 percent. This low real interest rate, however, did not help boost real growth in Britain--the country moved further into recession. Apparently, people expected inflation to come down in the future and therefore perceived real interest rates were higher.

By the same reasoning, perceived real interest rates in Western Europe may now be less than our measure indicates. In the fourth quarter of 1983, the nominal interest rate in the United Kingdom was 10 percent and inflation was 5 percent, leading to a real interest rate of 5 percent. If people expect a long-run rate of inflation of 9 percent (the 1960-83 average), rather than 5 percent (the fourth quarter 1983 rate of inflation), the current real rate of interest perceived by borrowers would be only 1 percent.

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Table 1

West European Real Interest Rates

	Average Real Interest Rates 1965-1983		Peak in Real Interest Rates	Real Interest Rates 4th Quarter 1983	Real Interest Rates at the Beginning of Economic Recovery in 1976
	<u>Mean</u>	<u>Median</u>			
West Germany	3.7	3.7	7.8 (81:3)	6.0	4.8
France	2.0	2.3	6.4 (82:4)	4.4	0.7
United Kingdom	0.4	1.7	7.3 (81:4)	4.9	2.1
Italy	-0.5	0.6	6.1 (81:3)	1.7	-2.9

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Table 2

Impact of a 3-Percentage Point Decline in
Real Interest Rates

(Percentage Point Change from Baseline)

1984

	Change in Real GNP Growth Rate	Change In Real Private Consumption	Change in Real Fixed Investment	Change in Unemployment Rate
West Germany	1.3	1.5	4.1	-0.6
France	1.0	0.8	3.1	-0.4
United Kingdom	1.1	1.7	3.3	-0.3
Italy	1.1	0.6	3.0	-0.1
Other Western Europe	0.7	0.4	1.1	-0.2
Total Western Europe	0.9	0.9	2.7	-0.3

1985

West Germany	1.6	1.0	4.1	-1.5
France	1.2	1.0	2.0	-0.9
United Kingdom	0.3	0.3	-0.3	-0.5
Italy	1.4	1.3	4.4	-0.4
Other Western Europe	0.8	0.7	0.4	-0.4
Total Western Europe	1.1	0.8	1.9	-0.8

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Table 3

Ratios of Government Deficits to GNP
(Percent)

	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983*</u>
West Germany	2.5	2.7	3.1	3.9	3.5	3.1
France	1.9	1.1	-3	1.9	2.6	3.4
United Kingdom	4.2	3.2	3.5	2.8	2.0	2.7
Italy	9.7	9.5	8.0	11.7	11.9	12.0
United States	-0.2	-0.6	1.2	0.9	3.8	3.9

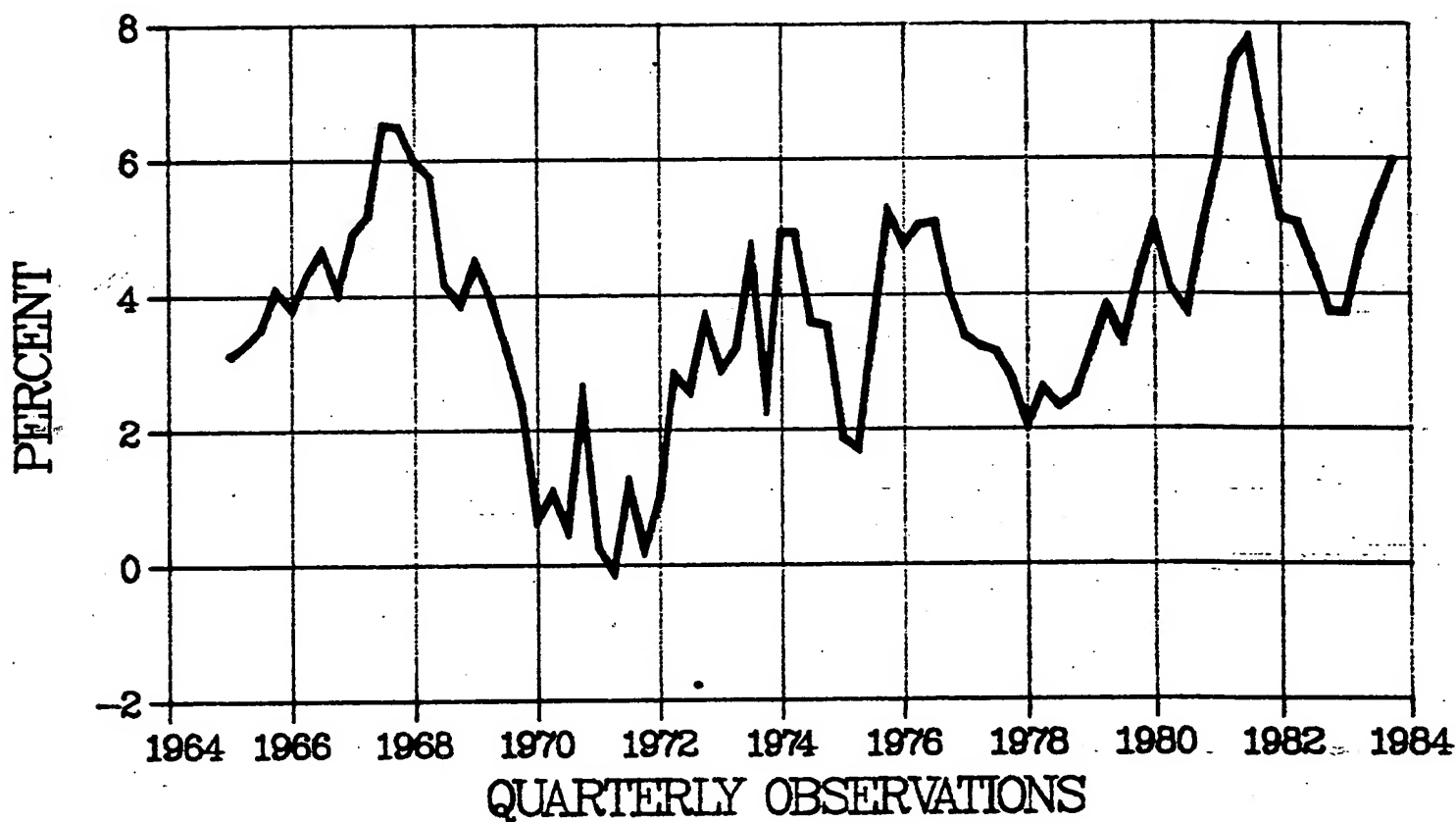
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* 1983 figures are preliminary.

Source: OECD Economic Outlook, December 1983, page 42. The figures are for the "General" government sector and thus include state and local as well as federal deficits.

FIGURE 1

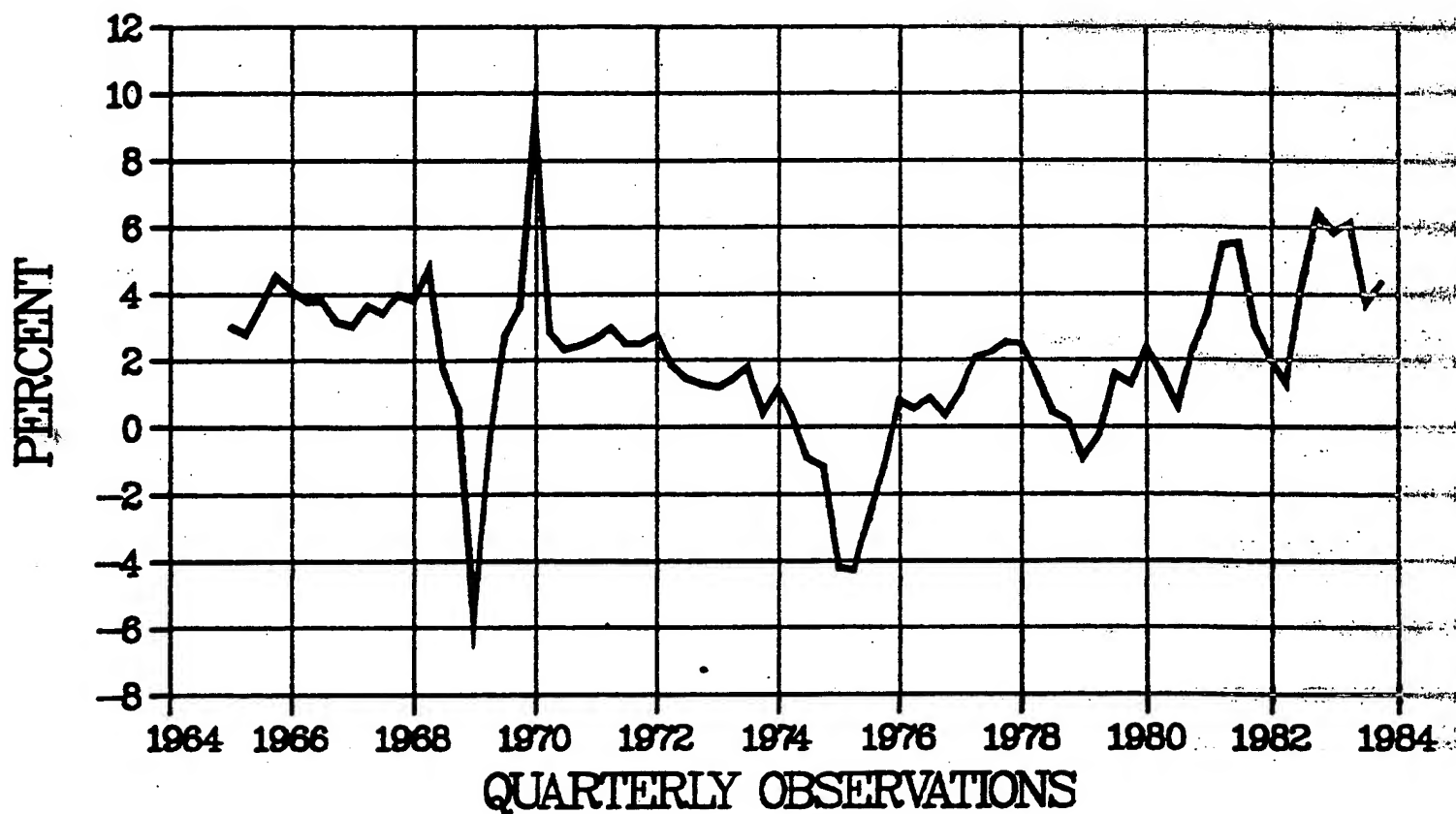
WEST GERMANY: REAL INTEREST RATE



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FIGURE 2

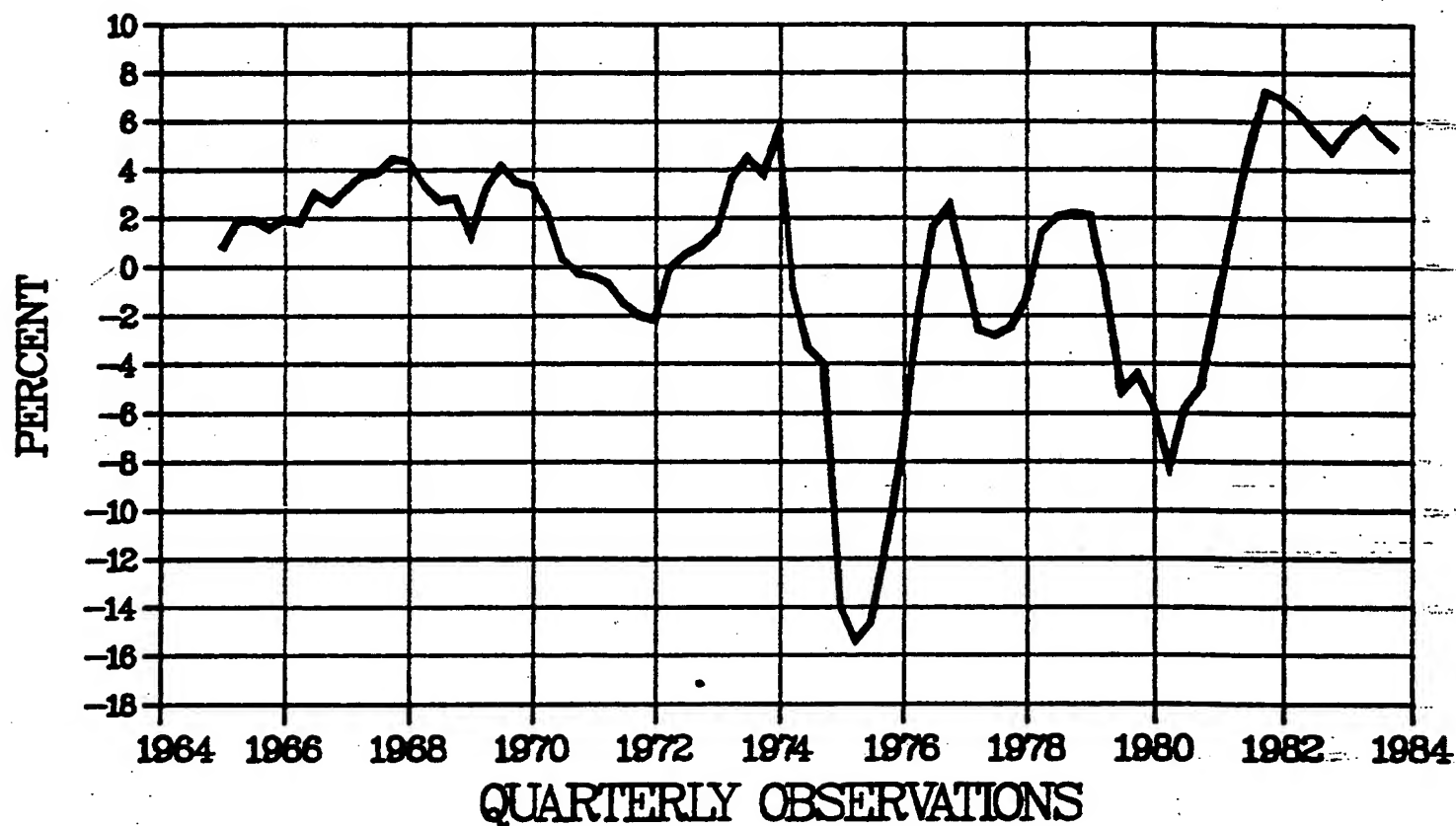
FRANCE: REAL INTEREST RATE



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FIGURE 3

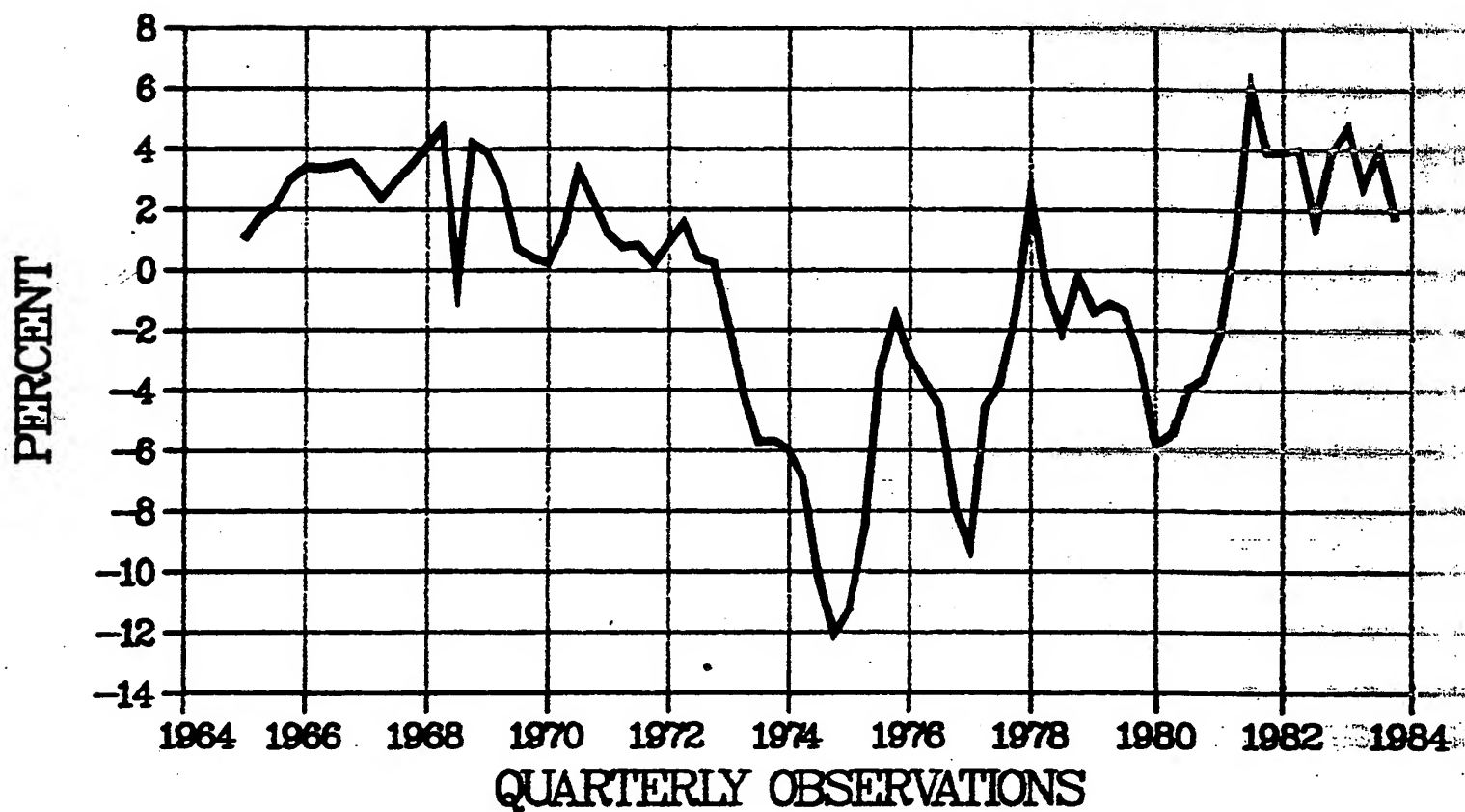
UNITED KINGDOM: REAL INTEREST RATE



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FIGURE 4

ITALY: REAL INTEREST RATE



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Distribution: Western Europe: Are Real Interest Rates High?

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